ECONOMIC SOCIETY OF AUSTRALIA
(VICTORIAN BRANCH) INC.

8TH STAN KELLY MEMORIAL LECTURE

GOVERNMENT AND THE COMPETITIVE PROCESS

Delivered by:

Ian McLachlan, A.O., M.P.

Wednesday, 22 May, 1991

Theatrette
State Bank Centre
385 Bourke Street
Melbourne 3000

FOREWORD

The Stan Kelly Memorial Lecture is held once every two years in Melbourne under the auspices of the Economic Society of Australia (Victorian Branch). The Lecture is funded from an endowment established by Mr Bert Kelly, former "modest" Member of Parliament and retired farmer, in memory of his late father.

William Stanley Kelly, OBE, was a South Australian farmer and life-long champion of free trade. He was a member of the Commonwealth Tariff Board from 1929 to 1939, an advisor to the Commonwealth Prices Commissioner from 1942 to 1948, chaired the Joint Dairying Industry Advisory Authority from 1951 to 1953 and was a member of the Consultative Committee on Import Policy from 1952 to 1960.

The Stan Kelly Memorial Lecture has as its theme, "The desirability of maintaining free the channels of trade throughout the world". Eight distinguished speakers have accepted invitations to deliver the Stan Kelly Memorial Lecture, beginning with Sir John Crawford in 1977 and followed by Mr J. Uhrig, Mr J. Stone, Mr R.A. Johnston, the Rt. Hon. R.J.L. Hawke, Mr J. McDonnell, Sir Leslie Melville and Mr I. McLachlan.

The text of Mr McLachlan's address is reproduced here as a permanent record of the eighth Stan Kelly Memorial Lecture delivered in Melbourne on 22 May 1991.

Mr Ian McLachlan, AO, entered Federal Parliament as the Member for Barker in South Australia on 24 March 1990. Prior to his election to Parliament, Mr McLachlan gained considerable experience through his involvement in business and agriculture. He maintains an active involvement in one of Australia's largest export industries as a woolgrower, with pastoral interests in South Australia, Victoria and New South Wales.

Ian McLachlan was President of the National Farmers' Federation for four years until his retirement in May 1988. Prior to this, he was President of the Wool Council of Australia for four years until May 1984 and Chairman of the Industrial Committee of the NFF. He served lengthy terms as a Board member of both Elders IXL and the South Australian Brewing Company. He was made an Officer in the General Division of the Order of Australia in 1989 for his services to primary industry.

The Council of the Economic Society of Australia (Victorian Branch) expresses its gratitude to Ian McLachlan for his willingness to prepare and deliver the eighth Stan Kelly Memorial Lecture.

Ian R. Harper
President

This year's Stan Kelly Memorial Lecture assumes a special significance.

The tireless efforts of both Stan and his son Bert Kelly to expose the folly of protectionist policies were vindicated just a couple of months ago by the announcement of the virtual removal of industry protection by the end of the decade.

Unfortunately this decision does not mean that the task they started is over.

Rather it is a beginning, an extremely important beginning, at a critical period for Australia.

Indeed circumstances have been critical in Australia for some years.

At the beginning of 1987, on Australia Day in fact, I suggested that the cause of Australia's economic malaise was similar to that of Argentina which, like Australia, had believed that protectionism was the way to prosperity. Both had subsequently demonstrated that to ape the industrial profiles of older economies was not to develop like them.

At that time, Australia was spending a mere $14 billion more than it earned. I said then "*I put it to you that this situation is not sustainable, and that is why the agenda for major structural change is gaining daily recognition.*"

It is no wonder that many of us almost five years later remain concerned that so little has been done about these problems that have been obvious for so long.

But here we are still flirting with 'solutions' which have been tried and discarded before - job creation schemes, printing money, positive industry assistance and the rest.

I hope I will be able to convince you that these sorts of solutions merely involve re-distribution of national wealth and in the process distort and in many cases damage the incentive to create more.

And whilst one is often tempted in difficult times to favour such schemes, I put it to you that the greatest job creation scheme of all would be to remove the man-made disincentives in the economy today that we have wasted so long a-building. And they are many.

I have often heard it said what a wonderful advantage it would be in this country if we could have a corporate tax rate which matched Hong Kong.

After all we have the natural advantages: minerals, the land, the socio-political stability. We even find ourselves on the edge of the burgeoning market of Asia, whereas not very long ago, our 'remoteness' was proclaimed a great negative and they say, add an attractive tax rate to these attributes and watch them flock in.

But who would be tempted to flock in? The answer is of course those who have succeeded in their own countries, where the sort of arrangements under which they work are more attractive than they are here.

How then would we attract these potential overseas investors and why will we be able to hold our current investors till they know that we can deliver these attributes which others do?

It would, apart from being the wrong way round, be unfair and unreasonable to try to attract new entrants to Australia where they cannot be sure of their industrial contracts, when State and Federal taxes stultify them, when they may not get their goods off the wharf on time, to operate under such an immense disadvantage. In fact we won't attract them until we make the changes.

So the order of events is of vital significance. Perhaps I can address them tonight, hoping you will agree with the significance, if not the order.

I don't need in this company to tell you that I believe that the removal of the distortions now in our economy is the single most important factor in putting us on the road to salvation, and if we do not do it ourselves, then no doubt it will be procured for us externally.

I believe we are commencing the process in Australia of focussing on the real issues that can produce the big rewards rather than those which cut those rewards down. But we are oh so slow.

As well as industry protection, we have the centralised wage fixing system, the telecommunications monopoly, lack of competition in most forms of transport and excessive regulation of business.

I would also add to this list our taxation system which weighs heavily against income generation and investment in productive enterprises and the predilection of successive governments to artificially stimulate the economy by increasing consumption, by spending and or printing money.

Many of these arrangements bestow favours on a small number of individuals at the expense of the rest of the community.

They almost all involve a redistribution of income and wealth which penalises the wealth creators.

Most importantly they inhibit competition and efficiency and as a consequence ensure that success is not based on individual merit and effort - but rather an ability to win special deals from government or at least a willingness to adapt to artificial incentives, an ability to work the system.

The cost to the community is not only financial, enormous though that is. The democratic process is effectively subverted because individuals are compelled to prop up or subsidise the select few. The payers are almost never party to the deal. Their costs - whether in dollars or in opportunities **lost - are hidden.**

In Australia, whether this subversion is due to a misunderstanding of the competitive process or deliberate manipulation doesn't really matter.
The answer is the same.

We are starting to see the true costs to the community and just beginning to wind back this array of disincentives and distortions.

The Stan Kelly Memorial Lecture is a tribute to a man - a family in fact - who warned of the hidden costs of industry protection long before it became even moderately fashionable.

However we are all destined it seems to invoking the same message over and over again. As one wise but frustrated observer of last century, Frederic Bastiat, political economist and member of the Paris National Assembly, put it:

> '*How much trouble there is in proving that two and two make four; and if you succeed in proving it, it is said "the thing is so plain it is quite tiresome," and they keep on legislating in the same old way, as if you'd proved nothing at all.*'

The sidelining of the tariff debate then is just the start. But it is a very important start, and an important precedent.

Not only is it vital because of the directly measurable costs of protection, but because increased exposure to international competition will eventually break down many other man-made structures and policies which hinder wealth and job creation.

It is quite obvious that the major unintended consequence of the Government's decision to reduce all industry protection to five per cent by 1996 will be the demise of the centralised industrial relations system as we know it because industry - like it or not - will demand that disappearance if it is itself to survive. That demise will provide jobs, more jobs, then profits, then even more jobs.

However that does not mean we can relax.

We cannot just rely on tariff cuts to prompt industry to increase investment in tradeable goods and services if, for example, a high interest rate policy pushes up the exchange rate and makes its task even harder, or if the tax system encourages distortionary investment in bricks and mortar.

And we should not rely on industry to extract the necessary changes. Surely it would make sense to facilitate these changes not least because we just do not have the time to wait.

And, as I have already hinted, there is a danger that, overwhelmed by bad economic news, we will be attracted to revamped, renamed versions of discredited arrangements because they promise instant albeit illusory relief.

One hundred years ago, in response to a similar crisis, we fell into this trap, establishing much of the rigid regulatory framework which is the underlying cause of our problems today.

We regulated the banks, we commenced the process of centralised wage fixing, we institutionalised everything that moved and as a consequence they ceased doing so.

Before moving onto what else remains to be done, however, I would like to deal with one or two of the remaining fears associated with reducing protection because I would be the first to agree that scepticism remains in the community about the sense of doing so in Australia when our trading partners are not so forthcoming.

"Australia should protect its industries to the same extent as its trading competitors" they say, and on the surface of it, it is an attractive argument.

But if we follow that argument through, why hasn't Australian manufacturing, which has enjoyed comparatively high protection for most of this century, thrived and why haven't our agriculture and mining sectors, which have not, been decimated on world markets?

I suggest that the reason is that constant international competitive pressures forced the latter to be efficient just to survive - whether they liked it or not. They had to adapt to market needs and continually seek out new markets.

On the other hand, our manufacturers were hidden from international competition and as a consequence we have emulated production patterns and techniques of long ago and virtually locked ourselves into preserving the moment of the establishment of protection.

Frederic Bastiat reasoned that if it were true that those countries with lower tariff barriers than their neighbours were at a disadvantage, why had so many of the former prospered, indeed prospered 'against all the rules'.

Indeed it is true that successful nations have been and are the great trading nations - within and without their own borders - and they have not waited for the rest of the world to remove their trade hindrances.

Imagine what the United States of America would be like today if each of the individual States had retained its own trade barriers.

These countries certainly may have used all their powers to persuade or force their neighbours to open their doors, but they accepted that whatever practices they indulged in they had to produce as efficiently as possible.

The Japanese and the United States markets are huge and extremely competitive internally but our domestic market is very small and just doesn't generate the degree of competitive pressure required to keep enterprises efficient. Nor is it lucrative enough in itself for many producers to exercise the economies of scale they would like.

We must therefore seek to extend our market by exporting and to achieve the degree of competitiveness required to do this we must have the pressure of foreign competition: it is the only way to the top.

A dollar of export income ultimately is no different to a dollar of import expenditure saved but exporting is the ultimate test of a country's competitiveness.

So I put it to you, support for Australia's unilateral reductions in industry protection is not an attempt to gain the economic high ground - it is first and foremost an exercise in self-interest.

Precisely the same arguments apply to calls for 'positive' industry assistance which is just protection under another name.

We must not fall into the trap of subsidising what we think are potential growth industries or propping up ailing industries as an alternative to promoting competition and international exposure.

As we all know, these schemes have one fatal flaw: <u>assistance of any form provided to one group in Australia must be paid for by another, in Australia</u>.

Who will pick the industries or firms? Is it wise for a small country such as Australia to put all its eggs into a few favoured baskets? And which baskets?

So the fact that other countries may indulge in government intervention from time to time is not relevant if we cannot match them, and if it makes us uncompetitive. As well, one finds, if one examines the reasons for Japan's success, for example, the allegedly all-seeing wisdom of the Ministry of International Trade and Industry (MITI) bureaucrats has very little to do with it.

The overriding factors in the case of Japan appear to have been an intensely competitive domestic market, a national priority to economic growth, low capital costs, co-operative labour, and the acceptance of the need for continual change and improvements including an acceptance of and learning from failure.

In short, Japan's success may be ascribed to <u>cheaper capital, flexible working arrangements and long working hours</u>.

There is not much comfort for the interventionists here, although there are sound lessons for us. But they are not new lessons and they are not too difficult to grasp.

Nevertheless, despite the lingering doubts, Australia is starting to take the right decisions in this area so that we may succeed - contrary to all the rules.

But exposure to competition in the product market is not being matched by an equal commitment to other areas which impact on production costs and investment and here I refer particularly to the labour market, the tax system and macro-economic policy.

I have little doubt that the cold winds of international competition will, eventually, force producers to take control over their industrial arrangements. If the Government were by some stroke of fortune to change overnight it would be sooner rather than later.

Currently we are experiencing the worst economic downturn since the 1930s Depression. There are more than 840,000 people unable to find work according to the Australian Bureau of Statistics and almost one million according to the Commonwealth Employment Service.

As the Coalition has found over the last few years and as I found as President of the National Farmers' Federation arguing in favour of genuine competition in the labour market is considered as heretical today as arguing against industry protection in the 1960s.

"The labour market is different" they say, "it is about people not goods and services".

Yet the arguments against industry protection apply equally and just as forcibly against labour market protection.

Ultimately, ironically, attempts to fix the price and the supply just encourage the market to seek - and find - alternatives. As a wool producer I can vouch for that from personal experience.

We in that industry tried to fix the price and the supply and the market wouldn't buy it - we finished up buying it ourselves.

There is absolutely no doubt that our centralised wage fixing system which determines wages and conditions without any regard for the capacity of individual enterprises to pay has acted as a significant depressant on productivity and real wage growth and job creation.

And it has all been done in the name of fairness to Australian workers.

Some of you will know of the King who decreed that people could only work with their left hands and not with their right.

> *'When workmen of all kinds are reduced to their left hands, imagine, sire,'* beseeched his vassals *'the immense number that will be needed to cope with the sum total of our present consumption of wealth, supposing it to be invariable.*
>
> *Such a prodigious demand for manual labour cannot fail to produce a considerable rise in wages, and pauperism will disappear from the land as if by magic.'*

Not much subtlety here but neither is there much in a system which has in the past endorsed claims for a reduction in working hours, at the same pay, whilst claiming to increase jobs.

We have a system which at this very moment of economic crisis gives unions monopoly rights so that they have enough clout to extract wage increases from employers which bear no relation to enterprise efficiency.

How many jobs would be created if we had no limits on the hourly price? Of course there would be full employment, or near enough to it.

Now I'm not advocating that there should not be a base hourly price for labour so as to prevent exploitation - I believe there should - but I'm making the point that just as the reserve price for wool limited the number of kilograms of wool that could be sold, the price of labour limits the number of units of labour which can be sold.

In fact I think it is far worse than this. It is arguable that the very worst thing that you can do for the young people of your country is to tell them how many rights, the right to freedom, the right to a good education, the right to health, they have and then let them find out that society won't allow them to exercise those rights, not even the right to work.

By putting up the absolute entry price of their labour that is exactly what we have done.

The obvious and simple solution is to give people a real choice. Just as now they are to be given a real choice between imported or locally produced products, let them choose whether or not they wish to belong to a union and let them choose which union if any they wish to join.

Also let them choose to move outside the Commission system and negotiate their own working arrangements to their mutual satisfaction.

If the centralised system is perfect then it has nothing to fear from the competition, but let's test it.

These proposals are so unobjectionable, the onus must be on the critics to demonstrate why their introduction would not be in the national interest.

The Business Council of Australia has estimated that poor labour productivity in Australian workplaces costs us some $20 billion a year.

My guess is that the lack of these arrangements costs this country between $30 and $50 billion a year.

In the key service sectors of the economy - the waterfront, coastal shipping, communications, rail transport - where a combination of a lack of competition backed up by explicit or tacit government support ensure that the rest of us, who are not parties to the deal, pay between 20 per cent and 50 per cent more for these services and a lot of others than our international competitors.

The solution is exactly the same: choice and competition, competition and choice.

But just as tariff reductions are not the only answer, labour market reform and microeconomic reform, although crucially important, do not provide the entire answer either. We need to consider several other matters.

Even if we do give enterprises the means to be efficient, Australians need access to competitively priced capital and they're <u>not</u> getting it because:

- the tax system encourages spending over saving, saving via superannuation, and encourages investment in property over more productive ventures, and

- prolonged high interest rates, reflecting high inflationary expectations, general economic uncertainty and lower domestic savings and positive and deliberate Government policy directly increase the pre tax cost of capital and also push up the exchange rate, thus discouraging investment in production of tradeable goods and services.

I believe that taxation policy in this country in the past either has not been based on any understanding of the wealth creation process, or that this knowingly has been discarded in favour of short-term expediency.

Ostensibly of recent times we have moved towards taxing all forms of income in full, but because of exemptions for the family home and the site on which it sits under the current capital gains tax, and incentives for superannuation, the bias against investment in productive or risky ventures has probably been exacerbated, whilst overall, the bias in favour of consumption over saving remains.

I am not arguing in favour of taxing the family home - indeed we would remove the distortion by removing the capital gains tax and replacing it with a tax on speculative gains only - nor against superannuation, but merely pointing out that a new set of distortions has been instituted.

Investment disincentives have been compounded by our reliance on high interest rates - for most of the 1980s in fact - first to prevent a so-called run on the dollar by attracting overseas funds, then maintained in the mid 1980s to keep those hot funds here, and finally in the last couple of years to kill off consumer spending and inflationary pressures and to prevent yet another run on the dollar in the wake of a deteriorating balance of payments.

The need for persistent high interest rates merely reflects an inability to come to grips with inflation and the wages system which essentially causes it.

The wages system causes inflation which causes high interest rates which decimate private industry and hold up the exchange rate thus penalising the producers of tradeable goods who we are relying on to improve our current account. This is what we have been doing for most of the 1980s: going around this unproductive loop.

The key is clearly to get rid of centralised wage fixing but we also must adopt a more stable and predictable approach to monetary policy with the objective of eliminating inflation and removing any chance for government to try to kick start the economy via yet another inflationary binge.

The Reserve Bank should be freed of political interference and given the autonomy - indeed the mandate - to achieve that objective and its task will be made much easier in conjunction with a comprehensive program of structural reform.

<u>The point is that government policy in all these areas must endeavour to ensure that individual efforts and energies are directed toward productive activity - or more precisely not discouraged from it - and not dissipated and wasted because of artificial distortions</u>.

Whilst I do not always agree with Tom Fitzgerald, the former financial editor of the Sydney Morning Herald and deliverer of last year's Boyer Lectures, he recently made a very important point.

He said that we require *"a general climate of economic circumstances including exchange rate and interest rate conditions that enables the whole trading sector to command resources on not less than fully equal terms against the sheltered industries. This is the true economic meaning of a 'level playing field' and it contradicts the careless use of the phrase when it is applied against manufacturing"*.

Australia has yet to take this to its heart - the inequalities are still there.

Australians must insist that governments understand their modest ability to create wealth through positive action.

They must insist that those same governments provide a competitive environment which encourages and rewards individual excellence and effort and innovation - in other words an environment where success (in all its forms) is determined on merit and effort and not on one's ability to sway the rules of the game.

Now is the time to re-assert a truly competitive framework.

We have seen too many diversions at too great a cost to our standard of living and individual freedom and equality of opportunity and we simply cannot afford any more.

You will see governments under pressure to create wealth through various schemes. There will always be pressures from Frederic Bastiat's candlemakers, those same candlemakers who petitioned for a law to literally block out their very unfair competitor, and destroyer of candlemaking jobs, the sun.

But the best thing governments can do to help the wealth creation process is to create a set of rules and ensure that everyone stays within them.

If we do this what can we realistically expect?

We can expect trade to be a little freer and a little fairer tomorrow than it is today.

We can expect the generation of more wealth in Australia by making our industrial arrangements within enterprises together for mutual profit under the protection of the rule of law.

We will create a set of circumstances where doing up one's house will still be desirable, but it would be even more desirable and rewarding to invest in export production which is so vital to this country's future.

And finally, inflation will be at such a point that we will draw in investment for the long term.

And to make sure that all these things come to pass we must continually implore the Kelly's and all the other Bastiats to expose the costs to Australia of doing otherwise.

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